BEFORE THE
PUBLIC SERVICE COMMISSION OF WISCONSIN

Application of the Milwaukee Water Works
for Authority to Increase Water Rates — Docket 3720-WR-108

SURREBUTTAL TESTIMONY OF PEIFFER BRANDT ON BEHALF OF MILWAUKEE WATER WORKS

Q. Please state your name and business address.

A. My name is Peiffer Brandt. My business address is 1031 S. Caldwell Street, Suite 100, Charlotte, NC 28203.

Q. Have you previously submitted direct and rebuttal testimony in this proceeding?

A. Yes.

Q. Have your read the direct and rebuttal testimony for this proceeding?

A. Yes.

Q. What is the purpose of your surrebuttal testimony in this proceeding?

A. After extensively reviewing the direct and rebuttal testimony, it is evident that there are five issues that have been raised by the intervenors and PSC staff: 1) customer demand ratios: 2) rate of return differential; 3) capital structure; 4) transmission and distribution allocation; and 5) public fire protection. The purpose of my surrebuttal testimony is to respond to the arguments around these issues. My surrebuttal testimony will close with a general observation.

CUSTOMER DEMAND STUDY

Q. Have you reviewed the Customer Demand Study prepared by Trilogy?

A. Yes.

Q. Are you aware of the concerns raised by the intervenors and PSC staff?

A. Yes. Mr. Behm, Mr. Planton, Mr. Rothstein, and Mr. Kaempfer, who represent the wholesale communities do not believe the study was robust enough to justify changing the demand ratios from the 2009-2011 Rate Case. They question various aspects of the study, particularly the timing of the data collection efforts, the number of customers included in the analysis, and the validity of some of the assumptions. Ms. Schmidt, a PSC staff member, raises the concern that the study is not robust enough to justify modifications to the demand factors. Finally, Mr. Hanser recommends the use of future peaking factors.

Q. Do you believe the analysis is sufficient to justify modifying the demand ratios from those used in the 2009-2011 Rate Case?

A. Yes. The demand ratios included in the 2009-2011 rate case are partially based on a study done in 1977. The data for these analyses is less reliable than the current analysis presented in the Customer Demand Study. In fact, not modifying the demand ratios would be more inaccurate as it relies on older data that was developed using similar assumptions. For example, the wholesale customers max hour demand in the 2009-2011 Rate Case is simply the max day demand times 1.43. The Customer Demand Study clearly shows that none of the wholesale customers have a max hour of exactly 1.43 times max day demand. Therefore, the wholesale intervenors are making the unreasonable claim that the use of a gross assumption is more appropriate than using demand factors based on substantial data collected over the last two years.

Q. What do you believe is the basis of Ms. Schmidt's concerns?

A. I am not certain of the basis for her concerns. Ms. Schmidt had the opportunity to read the direct testimony of the wholesale intervenors attacking the Customer Demand Study, but had not had a chance to see the rebuttal testimony submitted by Mr. Granum and Ms. Cramer. I am confident that when she reads the rebuttal testimony submitted by Mr. Granum and Ms. Cramer responding to the criticism of the wholesale intervenors that she will better recognize the value of the Customer Demand Study.

Q. What is your opinion of Mr. Hanser′s recommendation to use future peaking factors?

A. I think it is an interesting proposition in theory, but I do not believe determining future peaks is practical given the current situation. He claims that the network is designed to meet future peak flows. Again, in theory this makes sense, but since system design is not fluid, the system cannot be easily modified to meet future peaks. The system was designed many years ago based on a different set of expected future peaks, so historical peak flows actually better represent its actual design than future peak flows.

<u>RATE OF RETURN DIFFERENTIAL</u>

Q. Is it typical throughout the water industry, both in Wisconsin and nationally, for wholesale customers to be charged a differential rate of return?

A. Yes, wholesale customers located outside the city providing service are typically charged a higher rate of return because the owner of the utility, the customers of the utility within the city, have made an investment in the assets to provide service to the wholesale customers and are taking on the risk of serving these customers.

Q. What risks are MWW taking in serving the wholesale customers?

A. As mentioned in my rebuttal testimony, Rebuttal-MWW-Brandt-3 to 4, there are a number of risks. MWW does not hold sizeable cash balances, which is unusual for a utility the size of MWW. This lack of available cash places MWW at risk of having cash flow issues. MWW is experiencing declining consumption, with the test year consumption down 7% for retail and 8% for wholesale customers when compared to the test year usage levels from the 2010 rate case. MWW also has the risk that a wholesale customer could go elsewhere for its water purchases leaving MWW with stranded costs since the wholesale contracts have 10 year terms, but the investments MWW must make to serve these customers have useful lives much longer than 10 years. At least one wholesale customer, the Village of Shorewood, is currently evaluating an alternative water provider (Rebuttal-MWW-Brandt-4). MWW has an obligation to serve each customer. Finally, MWW has to cover any extraordinary operating costs, such as the estimated $5 million in additional O&M expenses associated with the harsh winter this year.

Q. The wholesale customers continue to point to the Kenosha case as a precedent for eliminating the differential rate of return. Are there differences between the Kenosha case and this case?

A. Yes, there are significant differences. As mentioned in my rebuttal testimony, Rebuttal-MWW-Brandt-6 to 7, the contract between the Kenosha Water Utility (KWU) and Pleasant Prairie Water Utility (PPWU) is more restrictive, preventing PPWU from purchasing water from any other providers and prohibiting the development of any alternative sources. The MWW contracts prohibit purchasing water from other providers but do not prohibit the development of alternative sources. In addition, the KWU-PPWU contract term is permanent, while the Wauwatosa contract term, for example, is 10 years. This difference is very important because it shows that there is more risk associated with the MWW wholesale contracts.

Q. What is the return the City receives from the 100 basis point differential?

A. Assuming the same level of total operating revenues ($94,863,483), the necessary rate of return for all customers would be 5.38%. Applying this in the model results in the wholesale customers' cost of service decreasing by $365,062 and the retail customers' cost of service increasing by the same amount. Therefore, the benefit to the retail customers of the differential rate of return is $365,062. If we apply this benefit to the investment of the City identified by Mr. Behm of $16,846,716 (Rebuttal-Wholesale Customers-Behm-6), then the "annual dividend" to retail customers, as Mr. Behm terms it, is 2.2%. This calculation is shown in Ex.-MWW-Brandt-10.

Q. Why does the percentage you calculated vary so much from the 17.3% "annual dividend" calculated by Mr. Behm?

A. In his analysis, Mr. Behm assumes a starting point of 6.25% for both customer classes. Doing so results in total operating revenues of $97,803,095 ($2,939,612 greater than MWW has requested). He then calculates the retail "savings" of reducing the retail rate of return to 5.25%. The fact of the matter is he has done an apples to oranges comparison. The additional $2.9 million is not savings to the retail customers, it is the amount of additional operating revenues MWW would recover at the higher rate of return, a level of operating revenues that MWW has not requested.

<u>CAPITAL STRUCTURE</u>

Q. What are the concerns regarding the capital structure and how could it impact MWW's rate filing?

A. The intervenors have expended comparatively less effort arguing the capital structure issue. However, Mr. Rothstein has raised concerns in his direct and rebuttal testimony that because MWW's capital structure is heavily weighted to equity it provides too great of a return to MWW. (Rebuttal-Wholesale Customers-Rothstein-2 to 3 and 5 to 6). In general, the objective of his testimony is to persuade the Commission to use an approach inconsistent with typical Commission practices due to the high level of equity so that MWW will receive less of a return, thereby lowering the revenue requirement and ultimately lowering the costs to be recovered from the wholesale customers.

Q. Does the PSC guidance require a capital structure of 50% equity and 50% debt?

A. No, the PSC Manual suggests that a favorable capital structure has "at least" 50 percent equity and "less" than 50 percent debt. Mr. Rothstein, Rebuttal-Wholesale Customers-Rothstein-6, mentions a quote from the PSC website, "The optimum capital structure is generally considered to be 50 percent equity and 50 percent debt." Even though this may be a benchmark for utilities to consider, each utility should evaluate its own current financial position and future prospects before blindly moving to this capital structure. For example, limiting a utility that is serving a growing service area to such a rule of thumb could stifle growth because the utility would not be able to issue the debt necessary to construct the assets to support the growth. At the same time, requiring an aging utility without growth, that will likely face significant capital repair and replacement costs as some of its major assets could put the utility at risk of having the future debt capacity necessary to efficiently fund these future costs.

Q. Does the AWWA Manual M1 require a capital structure of 50% equity and 50% debt?

A. No, as mentioned in my rebuttal testimony, Rebuttal-MWW-Brandt-10 to 11, the Manual M1 suggests that if a utility's allowed rate of return is to be based on its weighted average cost of capital then it may be appropriate to use a capital structure of 50 percent equity and 50 percent debt to calculate the weighted average cost of capital if a utility has an atypical capital structure. This is not relevant in this case since the Commission uses a "capital structure neutral" approach in determining the allowable rate of return**.**

Q. What benefits does MWW derive from having the capital structure that it has?

A. Because MWW has a capital structure with a low ratio of debt to equity, it has low interest payments. Due to the low interest payments, MWW will be able to utilize more of the return on rate base for funding main replacements. The low debt to equity ratio also provides MWW with the capacity to issue debt in the future. Given the age of the system, there is likely to be major repair and replacement efforts in the future. Without this capacity to issue debt, MWW could be forced to fund these efforts with rate funded capital, which could result in a spike in the rates for all customers.

Q. Is the $16 million return that Mr. Rothstein references, Rebuttal-Wholesale Customers-Rothstein-3, a function of MWW's capital structure?

A. No, not directly. The return on rate base is calculated by multiplying the blended rate of return, 5.38% (from 5.25% retail and 6.25% wholesale) and the Net Investment Rate Base ($336,130,621), which is $18,068,552. Since neither the blended rate of return nor the Net Investment Rate Base is a function of the MWW's capital structure then the $16 million is not directly linked to MWW's capital structure. Where there is a linkage is that the $16 million figure comes once the interest on debt service is subtracted from the return on rate base. Since MWW has a low debt to equity ratio, it has relatively little annual interest expense, so the just over $18 million in return on rate base is only reduced to $16 million.

Q. Therefore, is the return on rate base reasonable?

A. It is reasonable, and it will allow MWW to do the level of main replacement identified without having to issue additional debt. The $16 million will be reinvested into the system, as mentioned in Rebuttal-PSC-Anne Waymouth-2. Responding to Rebuttal-Wholesale Customers-Rothstein-5 to 6, if the return is lowered because of a hypothetical return calculation based on a capital structure that Mr. Rothstein believes is appropriate, then MWW would have to issue debt to do the level of mains replacement proposed by MWW based on recommendations from PSC staff. Doing so would increase annual interest costs in the future, reducing the amount of return on rate base MWW could reinvest in the system.

TRANSMISSION AND DISTRIBUTION ALLOCATION

Q. What is the issue regarding the transmission and distribution lines?

A. There are two ways to allocate the water main assets between transmission and distribution lines: 1) based on actual costs of installation of the line; and 2) based on length times diameter (inch-feet).

Q. How does using one approach versus the other impact the rate case?

A. The two methodologies provide different allocations of mains between distribution and transmission. The actual cost approach allocates 71% of the water main assets to distribution mains and 29% of the assets to transmission mains, while the inch-feet approach allocates 60% of the water main assets to distribution mains and 40% of the assets to transmission mains. As a result, these percentages determine how much depreciation and return on rate base are allocated to transmission and distribution. Wholesale customers are not allocated any of the distribution costs, so the percentage has a material impact on the rates that are calculated for each customer class.

Q. What are the positions of the various parties regarding this issue?

A. Mr. Planton and Mr. Rothstein, on behalf of the wholesale intervenors, have argued for utilizing the original cost approach in their direct and rebuttal testimony (Rebuttal-Wholesale Customers-Planton-4 and Rebuttal-Wholesale Customers-Rothstein-9 to 10). Mr. Hanser, on behalf of MillerCoors, supported utilizing the inch-feet approach in his rebuttal testimony (Rebuttal-MillerCoors-Hanser-8). MWW, through Direct-MWW-Wright-5 to 6 and Rebuttal-MWW-Wright-11 to 13, also supports utilizing the inch-feet approach.

Q. Why do you believe the inch-feet approach is more appropriate?

A. As discussed in the rebuttal testimony of Mr. Hanser and Mr. Wright, the cost approach is skewed because the cost of mains changes over time. The example provided by Mr. Hanser does an excellent job of conveying this point (Rebuttal-MillerCoors-Hanser-8). Also, the oldest mains, which is where the costs are going to be incurred in the near future, contribute the least to the allocation, so there is a disconnect between the allocations and the costs incurred for maintenance, repair, and replacement. The inch-feet approach eliminates these issues.

PUBLIC FIRE PROTECTION

Q. What are the issues that have been raised around public fire protection?

A. There are two issues that have been raised around public fire protection. One is the allocation of public fire protection costs to wholesale customers as raised by the wholesale customer witnesses and the other is the magnitude of the fire demand that should be used for allocating public fire protection costs as raised by Mr. Shannon in his rebuttal testimony.

Q. What are the wholesale intervenors′ concerns?

A. The wholesale intervenors have raised concerns about the allocation of fire protection to wholesale customers. Mr. Kaempfer has testified that from an operational perspective due to certain improvements within their systems, the wholesale customers can meet their own fire flow needs. Mr. Behm and Mr. Rothstein have testified that the wholesale customers should not have any fire protection costs allocated on more general and theoretical grounds.

Q. Do you agree with Mr. Kaempfer′s analysis of the fire protection capabilities of the wholesale customers?

A. I do not claim to be an expert so I cannot offer an opinion on the details of his analysis. I can speak to it in a more general way that is relevant to the allocation of public fire protection costs. On the face, his argument can be persuasive, but it does not tell the whole story. When the wholesale customers take an asset out of service, they have MWW providing the redundancy necessary to ensure fire protection for the wholesale customer. When MWW takes an asset out of service to perform routine maintenance, it does not have another utility to provide back-up service. Therefore, MWW has built a system with redundancy to provide protection when portions of the system are down. By having MWW as a backstop, the wholesale customers do not need to provide the level of redundancy, so they are receiving some benefit from MWW even if they can meet fire flow with all their assets in service and the tanks full at the beginning of a fire. In addition, as Mr. Pauly points out, Rebuttal-MWW-Pauly-3 to 4, MWW would be impacted by any fire event for one of the wholesale customers as such an event would trigger MWW refilling the wholesale customer's storage or pressurizing the wholesale customer's system.

Q. Do you agree with Mr. Shannon's concern about the fire demand basis?

A. As mentioned in my rebuttal testimony, I have some concerns about the population method, similar to those expressed by Mr. Shannon. There is not a direct link between population and the true fire demand. Also, the method results in the total demand being much higher than what seems intuitively to be the case. However, given the trade-offs and the difficulty with developing fire demands that are reproducible and can be relatively easily updated, we believe the population-based demand approach for determining public fire demand is reasonable. At the same time, MWW would not be overly concerned if total demand was lowered, which would have the effect of shifting costs from recovery through the public fire charge to the general services. MWW remains in favor of working with the PSC to develop an approach for developing fire demand that more equitably allocates public fire protection costs for all its customers.

Q. Were you surprised by the opinion Mr. Shannon provided in his rebuttal regarding allocating fire protection costs to the wholesale customers?

A. Yes. Mr. Shannon indicated that he agreed for the most part with the wholesale intervenors based on the argument that the communities have their own storage capacity. He does not provide any more support for his opinion. I would suspect that as he reads the rebuttal testimony provided by Mr. Pauly and Mr. Wright and considers this issue in more detail, he may better recognize how MWW provides a benefit to the wholesale customers regarding fire protection, and as a result how the wholesale customers should be responsible for a share of the public fire protection costs.

GENERAL OBSERVATIONS

Q. In your rebuttal testimony you expressed your opinion that MWW attempted to develop a balanced cost of service and rate design in a transparent manner. Have you changed your mind based on the rebuttal testimony that you have reviewed?

A. Absolutely not. In fact, I believe the direct and rebuttal testimony have shown exactly what I was expressing. MWW has been challenged from different intervenors on the same issue with the intervenors taking different positions. As would be expected, each intervenor is attempting to have its share of the revenue requirements decreased. MWW wants to continue providing high quality service to all of its customers and recover the costs for providing this service equitably. We believe our recommended approach equitably allocates costs to all customer classes. We have attempted to lay out the support for our recommended approach in a transparent, concise, and simple to understand manner, including providing a model that shows all the calculations within the cost of service and rate design.

Q. Does this conclude your surrebuttal testimony?

A. Yes, it does.